Municipal Finance After the Detroit Bankruptcy

By Patrick F. McGow

Detroit's bankruptcy dominated the headlines in 2013 and 2014. When the city filed for bankruptcy on July 18, 2013, it was the largest Chapter 9 municipal bankruptcy filing in U.S. history. The petition cited more than $18 billion of debt and the city's inability to provide basic services or fulfill its obligations to its citizens or its creditors. At the time, few observers thought the proceedings could be completed quickly given the magnitude of the issues facing the court and the fact that a Chapter 9 municipal bankruptcy is fairly rare with limited judicial precedent. Nevertheless, Detroit's whirlwind historic bankruptcy case concluded in 17 months when U.S. Bankruptcy Judge Steven Rhodes confirmed the city's plan on November 7, 2014,[1] and Detroit officially exited from bankruptcy on December 10, 2014.

The circumstances that led to the Detroit bankruptcy filing have been widely reported and will not be repeated here.[2] Not every county, city, village, and township in Michigan is facing insolvency or a financial crisis, but many municipalities are experiencing some of the same financial pressures and revenue constraints that were present in Detroit. The increased cost of providing pension and healthcare benefits to retirees coupled with decreasing revenues are common problems for Michigan's local units of government.

Many observers predicted the Detroit bankruptcy would have a crippling effect on the ability of other Michigan municipalities to access financial markets. That did not happen, however. But what did we learn from the Detroit bankruptcy, and what lessons can other Michigan municipalities learn from the city's financial crisis?

The Detroit bankruptcy

Municipal bankruptcies are rare in the United States. Under the federal Bankruptcy Code, there must be clear authority in state law for a local unit of government to file for bankruptcy, and only about half of the states allow municipalities to file. Municipalities that file for bankruptcy must do so under Chapter 9 of the Bankruptcy Code,[3] which is limited to municipalities, not the Chapter 7 liquidation or Chapter 11 reorganization used by private entities.

Detroit estimated its $18 billion in liabilities included $6.4 billion in secured debt and $11.9 billion in unsecured debt.[4] The unsecured debt included $3.5 billion in unfunded pension obligations and $5.7 billion for "other post-employment benefits," which consisted of both health and life insurance benefits for retirees.[5] The unsecured debt also included $1.43 billion of certificates of participation related to pensions and $651 million in general obligation bonds.[6] The stage was set for a battle among creditors as to the relative seniority/priority of pension liabilities, post-employment benefits liabilities, and various types of general obligation bond debt.[7]

The biggest legal question presented in the Detroit bankruptcy was whether the bankruptcy court could cut pension benefits to Detroit retirees. The Michigan Constitution prohibits the impairment of accrued public pension benefits, stating, "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."[8] Despite the constitutional protection, Judge Rhodes ruled

early in the case that pension rights under the Michigan Constitution are contractual rights subject to impairment in a federal bankruptcy proceeding:[9] "[t]he Bankruptcy Clause of the United States Constitution, and the bankruptcy code enacted pursuant thereto, explicitly empower the bankruptcy court to impair contracts and to impair contractual rights relating to accrued vested pension benefits. Impairing contracts is what the bankruptcy process does."[10]

One question Judge Rhodes did not address, but which may be an issue in other states, is whether the Michigan Constitution also protects other post-employment benefits. The Michigan Supreme Court answered that question a decade ago in *Studier v Michigan Public Schools Employees' Retirement Board*,[11] holding that post-employment benefits are not "accrued financial benefits" protected by the Michigan Constitution.[12]

The ability to alter pension benefits, post-employment benefits, and other unsecured debt obligations allowed Detroit greater flexibility in crafting its restructuring plan. One of the unique features of a Chapter 9 bankruptcy is that only the local government (in this case, Emergency Manager Kevyn Orr on behalf of Detroit) can file a restructuring plan, which is then submitted for approval by the bankruptcy court. Detroit was able to enter into settlements with various creditors to shed $7 billion of debt and provide for reinvestment of $1.5 billion back into city services and infrastructure over 10 years.[13]

Fast Facts

The Detroit bankruptcy restructuring plan was accomplished through settlements with its major creditors, allowing Detroit to shed $7 billion of debt and provide for reinvestment of $1.5 billion in city services and infrastructure.

Although the Michigan Constitution protects accrued pension benefits of state and local government employees in public pension and retirement plans, a federal bankruptcy court may alter and reduce pension benefits and other post-employment benefits, including health insurance benefits for retirees. The court and the bankruptcy plan may treat pensioners and bondholders differently.

Lessons learned from the Detroit bankruptcy

Because Detroit reached settlements with its major creditors, the case established very few legal precedents. However, the case and its settlements can offer a few lessons:

- **Pension benefits may be reduced in bankruptcy**. As noted previously, Judge Rhodes ruled on this key point early in the case.
- **Not all holders of general obligation debt will be treated the same**. The settlements reached in the bankruptcy case with holders of debt differed depending on the type and structure of the general obligation debt. The insurers of Detroit's unlimited tax general obligation bonds, which were approved by voters and paid for by a dedicated millage, will recover 74 percent on the dollar.[14] Limited tax (nonvoted) general obligation bondholders will recover 34 percent.[15] Holders of the controversial certificates of participation will recover only 14 percent.[16]
- **A general obligation pledge is not the same as a security interest**. Detroit's general obligation pledge does not mean what bondholders and bond insurers thought it meant. The court's approval of the settlements and treatment of the different classes of bondholders shows there was no security interest created.
- **Pensioners may be treated more favorably than bondholders**. Although Detroit cut pension and post-employment benefits and terminated cost of living adjustments, the reduction to pension payments was less than 5 percent compared to the much larger reductions for bondholders.[17] Judge Rhodes indicated that Detroit was justified in treating its pensioners better than other unsecured creditors in part because Michigan voters approved a constitutional amendment to protect pensions. In addition, the fact that many pensioners live in and around Detroit increased the city's economic recovery and ability to pay its creditors.

One key question that was not directly addressed in the Detroit bankruptcy was whether unlimited tax general obligation bonds are secured or unsecured. Because the insurance companies, who insure these bonds, settled with Detroit, the question did not have to be answered by Judge Rhodes.

It is not clear whether any other Michigan municipalities will file for bankruptcy under Chapter 9. Under Michigan law, a local unit of government cannot file for bankruptcy without first proceeding with a multistep process involving some form of restructuring effort required by the Local Fiscal Stability and Choice Act, Act 436 of 2012.[18] Furthermore, a local unit of government cannot file for bankruptcy without the written approval of the governor.[19] As of the date this article was written, 13 Michigan municipalities and five school districts were operating under Act 436.[20]

It is too soon to tell whether and how Detroit's bankruptcy will affect other Michigan municipalities, particularly those that are fiscally distressed. Even the two major rating agencies disagreed on the impact of the bankruptcy exit plan. Moody's expressed concern about the favored treatment given to pensioners at the expense of general obligation bondholders and the impairment of general obligation bonds. Standard & Poor's stated the exit plan will not set a legal precedent and does not change its outlook on municipal general obligation ratings, including limited tax general obligation ratings.[21] The doom-and-gloom predictions that bondholders would not buy bonds from Michigan municipalities have not occurred. Detroit itself sold bonds during and upon exiting from bankruptcy.

Financial stresses on Michigan municipalities

The vast majority of Michigan municipalities are nowhere near Detroit's dire financial situation. However, some of the same factors that caused the fiscal stress in Detroit are also problematic for other Michigan municipalities. Many municipalities receive most of their general fund revenue from two sources: property tax revenues and state-returned revenues. Both sources of revenue have been restricted or declining for more than a decade, even before the steep decline in property tax values that began in 2008.

Property tax revenues have been limited in growth by two constitutional amendments—the Headlee Amendment in 1978 and Proposal A in 1994. The Headlee Amendment was designed to limit the ability of local governments to levy new taxes and limit the growth of property tax revenues by requiring local governments to roll back their millage rates to reduce revenues when existing property values in the community increase more than inflation.[22] Proposal A created a new property tax methodology to limit the increase in taxable value of a property to the lesser of the rate of inflation, or 5 percent, until the property is sold or transferred.[23] Together, these constitutional amendments and the corresponding changes to the property tax laws have made it more difficult for Michigan municipalities to generate sufficient property tax revenues. In fact, a 2005 Plante Moran report described the Michigan municipal finance model as "broken."[24] A 2014 study by the Southeast Michigan Council of Governments analyzed the reduction of property

tax revenues since the beginning of the Great Recession in 2007 and concluded that a startling number of communities in southeast Michigan are dealing with a loss of one-third to one-half of their tax base.[25]

The other major revenue source for Michigan municipalities is statutory revenue sharing, which is a program to distribute a portion of state-collected tax revenues, derived mainly from the state sales tax, to local governments.[26] That, too, has been dramatically reduced by the state for more than a decade. One recent estimate calculated the reduction in statutory revenue sharing to more than $6 billion for local governments from 2002 to 2014.[27]

On the expense side of the ledger, the legacy costs that featured prominently in Detroit's bankruptcy also threaten the fiscal health of many Michigan municipalities. Pension and other post-employment benefits costs are at the forefront of local government budget discussions and on the radar screen of policymakers in local governments and in Lansing. A 2011 Michigan State University study found that 311 of Michigan's 1,773 cities, villages, and townships provided some level of post-employment benefits, with the unfunded liability totaling $12.7 billion, including an estimated $4.9 billion for Detroit alone.[28]

This is not to suggest there will be hordes of Michigan municipalities following Detroit into bankruptcy. But due largely to the existing legacy costs and restrictions on the ability of local governments to generate revenues, the fiscal health of our local units of government will not recover as quickly after the Great Recession as other sectors of the economy. ■

Patrick F. McGow is a principal with the law firm of Miller, Canfield, Paddock and Stone, PLC, based in Detroit. He is a co-leader of the firm's Public Law Group and represents a variety of governmental clients, concentrating in municipal finance, bonds, tax increment financing, redevelopment projects, and other related municipal legal issues.

ENDNOTES

1. Judge Rhodes orally confirmed Detroit's Plan of Adjustment on November 7, 2014. The Order Confirming Eighth Amended Plan for Adjustment of Debts of the City of Detroit was entered on November 12, 2014. *In re City of Detroit*, unpublished order of the U.S. Bankruptcy Court for the Eastern District of Michigan, entered November 12, 2014 (No.13-53846) <http://www.kccllc.net/detroit/document/1353846141112000000000018>. All websites cited in this article were accessed August 9, 2015.
2. See, e.g., Bomey & Gallagher, *How Detroit Went Broke: The answers may surprise you—and don't blame Coleman Young*, Detroit Free Press (September 15, 2013) <http://archive.freep.com/interactive/article/20130915/NEWS01/130801004/Detroit-Bankruptcy-history-1950-debt-pension-revenue>. See also Fourth Amended Disclosure Statement with Respect to Fourth Amended Plan for the Adjustment of Debts of the City of Detroit, *In re Detroit*, No.13-53846 (May 5, 2014) (providing a comprehensive review of those circumstances that led to Detroit's bankruptcy filing) <http://www.kccllc.net/detroit/document/1353846140505000000000005> (the "Disclosure Statement").
3. 11 USC 901 *et seq.*
4. See Opinion Regarding Eligibility, *In re Detroit*, No.13-53846 (December 5, 2013) p 7 <http://www.mieb.uscourts.gov/apps/courtOpinions/opinions/OPINION%20REGARDING%20ELIGIBILITY%2012.5.131.pdf>.
5. *Id.* at 8.
6. *Id.*
7. See Moody's Investors Service, *Detroit Bankruptcy May Change How Other Distressed Cities Approach Their Pension and Debt Obligations* (July 26, 2013) <http://media.mlive.com/news/detroit_impact/other/Detroit%20Bankruptcy%20May%20Change%20How%20Other%20Cities%20Approach%20Pension%20and%20Debt.pdf>.
8. Const 1963, art 9, § 24.
9. Opinion Regarding Eligibility, p 80.
10. *Id.* at 74.
11. *Studier v Michigan Pub Sch Employees' Retirement Bd*, 472 Mich 642; 698 NW2d 350 (2005).
12. *Id.*
13. See Eighth Amended Plan for the Adjustment of Debts of the City of Detroit, *In re Detroit*, No.13-53846 (May 5, 2014), sched I.A.9, I.A.126, I.A.197, I.A.237, I.A.250.a and I.A.250.b, I.A.254.a and I.A.254.b, I.A.298, I.A.344, and I.A.360 <http://michigan.gov/documents/treasury/Detroit_-_Eighth_Amended_Plan_of_Adjustment_476086_7.pdf> (the "Plan of Adjustment").
14. *Id.*, sched I.A.360.
15. *Id.*, sched I.A.237.
16. *Id.*, sched I.A.197.
17. *Id.*, scheds I.A.250.b and 254.b.
18. MCL 141.1541 *et seq.*
19. MCL 141.1566.
20. According to the Michigan Department of Treasury website at <http://www.michigan.gov/treasury/0,4679,7-121-1751_51556_64472-201116--,00.html>, as of August 12, 2015, the 13 municipalities (Allen Park, Benton Harbor, Detroit, Ecorse, Flint, Hamtramck, Highland Park, Inkster, Lincoln Park, Pontiac, River Rouge, Royal Oak Township, and Wayne County) and five school districts (Benton Harbor Area Schools, Detroit Public Schools, Highland Park School District, Muskegon Heights School District, and Pontiac Public Schools) have some form of oversight under Act 436.
21. Standard & Poor's Ratings Services, *Why Detroit's Bankruptcy Plan Outcome Doesn't Affect U.S. Municipal General Obligation Ratings* (November 7, 2014).
22. Const 1963, art 9, § 31.
23. Const 1963, art 9, § 3.
24. Plante Moran, *System Failure: Michigan's Broken Municipal Finance Model* (2005) <https://www.mml.org/advocacy/resources/system_failure_executive_summary.pdf>.
25. Southeast Michigan Council of Governments, *Running on Empty: SEMCOG's Local Government Revenue Task Force Report* (November 2014) <http://library.semcog.org/InmagicGenie/DocumentFolder/RunningOnEmpty.pdf>.
26. See MCL 141.901.
27. Minghine, *The Great Revenue Sharing Heist*, The Review (February 2014) <http://www.mml.org/pdf/advocacy/mml-revenue-sharing-heist-2014.pdf>.
28. Scorsone & Bateson, *Funding the Legacy: The Cost of Municipal Workers' Retirement Benefits to Michigan Communities*, MSU Extension White Paper (March 14, 2013), p 5 <http://msue.anr.msu.edu/uploads/236/33228/MI_Municipal_Worker_OPEB_Costs_2013-03-14-13_update.pdf>.